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Hostile Take-overs in Ukraine

Edilberto Segura, Andrey Bubnovsky

In recent years, Ukraine experienced a significant growth of foreign direct investment (FDI) in banking, retail, energy, metals and other sectors of the economy. A number of Ukrainian companies completed successful initial public stock offerings (IPOs) on the international capital markets. Well known international companies either consider or announced their plans to invest in the country. The sustained foreign direct investment (FDI) inflow depends on the favorable investment climate in the country, which, in turn, requires an effective mechanism for property right protection. The corporate legislation that meets international standards and efficient judicial system are most essential mechanisms in safeguarding the investors' property rights. Ukraine's progress in development of corporate legislation and efficient judicial system is rather slow. Due to their weakness Ukraine witnessed a surge of so called "raidering" attacks or illegal takeovers of corporate assets. Such attacks are detrimental to the image of Ukraine among international investors who might hold their investment decisions.

Background

In 2005 – 2006, Ukrainian businesses were exposed to more than 2 000 "raidering" attacks" according to the estimates of the Ukrainian Union of Industrialists and Entrepreneurs (UUIE). Currently, there is no official definition of "raidering". Some officials refer to "raidering" as "unlawful attainment of control over companies' assets and operations" while others speak of "raidering" as "hostile takeovers" in general. In the US and the UK many people define a corporate raid as a particular type of hostile takeover in which the assets of the purchased company are immediately sold off or liquidated. The hostile takeover is not unusual and illegal practice in the Western business practice; it usually means that company acquisition takes place despite management opposition. The stockholders of such companies are willing to sell their shares with no detriment to the assets of these companies.

In Western practice, takeovers are subject to closer supervision than in Ukraine. For example, takeovers (acquisitions of public companies) in the UK are governed by the City Code on Takeovers and Mergers. The Code used to be a non-statutory set of rules on a voluntary basis that became statutory as part of the UK's compliance with the European Directive on Takeovers. The Code established safeguards to protect shareholders equality in takeovers and mergers.

Ukrainian business practices in hostile takeovers and defense tactics follow the international experience in many regards. The "Obolon" and "Rosinka" companies successfully prevented the hostile takeover attempts. Since the corporate legislation in Ukraine is still under development, the shareholders are not well protected; and businesses exploit the loopholes in the law in their aggressive takeover strategies. Many takeovers turned into overt illegal seizure of corporate assets

with gross violation of rights of the shareholders. In this regard, it is critical to improve the government regulations that would incorporate best practices in protecting the rights of the shareholders, as well as rules and procedures in M&A activities.

As a part of this effort, the term “raidering” should be clearly defined. The “raidering” is now confused with corporate conflicts, referred to cover mismanagement of companies as well as the officials and executives’ embezzlement and other crimes, labor conflicts, and even defense tactics against hostile takeovers.

The patterns of “raidering” in corporate conflicts are recognizable when shareholders’ meetings are held with violations of established procedures of the company and law, documents are forged, poorly justified lawsuits are filled in different courts and other illegal actions performed with an aim of gaining control over targeted assets (companies). The illegal deeds committed in this type of hostile takeovers fall within the scope of Criminal, Administrative Codes and other legal acts. The term “raidering” is confusing and inadequate given the international practice. This issue should be rather treated as a corporate conflict, and actions with the patterns of “raidering” classified as breaches of law with “aggravating circumstances”.

It is essential to improve corporate legislation and judicial system in compliance with international standards. The efficient financial market is a mechanism that allows raising equity capital for the company at a low transaction cost. Equity is a cheapest source of capital that is invested into a company in exchange for an ownership interest in that company. In Ukraine, companies issue stock primarily to change ownership structure and rarely raise capital for the company. Increasing shareholders value is also hardly a priority in managing the company. Immature capital (securities markets) market and slowly progressing reform of corporate law are the impending factors that impair the growth of domestic and foreign investments. The illegal schemes used to seize the shareholders’ assets further worsen the situation.

Hostile takeover schemes and methods

The hostile takeover schemes are becoming more sophisticated. In general, takeovers could be classified into the following categories:

1. Company stock.

This is very similar to the stock market acquisitions in the Western business practice. The “hostile company” buys the outstanding shares of the company and initiates the shareholders’ meeting to change executives and the Board. In Ukraine, the main objective is to appoint a new General Manager which allows gaining control over the company operations. The purchase of 10% of company’s authorized capital (stock) allows convening a shareholders’ meeting and putting issues on the meeting’s agenda. In order to improve its chances to approve “necessary” decisions at the shareholders, the “hostile company” preferred method in illegal takeover is to file a lawsuit and get either the “court decision” on securing the plaintiff rights” before the final court decision and/or verdict on the plaintiff case. The “court decision” may suspend the company chief executive or even appoint a new acting chief executive and remove the company seal, freeze the shareholders’ shares before the shareholders’ meeting etc. This type of court decision might be immediately put

into effect. As to the court verdicts they might be announced in a time frame when companies either do not have time to fill an appeal, or time allowed for an appeal expires. The situation is further aggravated that lawsuits might be filled in the courts of arbitration and civil courts. The courts accept claims where the plaintiff is located (registered). The plaintiff may register residence at a different location and file a new claim. The similar lawsuits might be heard at different courts and verdicts approved without the defendant knowledge of the lawsuits. The court hearing notice might be delayed after the court hearing. Furthermore, the courts do not have to verify the accuracy and authenticity of the submitted documents. The judges might rule in favor of “hostile company or person” on the basis of falsified documents, and procedure of invalidating the wrongful decision is complicated. In this case, “hostile company” might file claims and appeals in different courts, and even get conflicting courts decisions. In a meantime, the “hostile company” has time to buy and/or issue new shares and manage assets of the “seized” company. It also obtains access to the company’s shares registry.

The courts’ approve decisions to ban shareholders meetings, create another registry without original documents, transfer chief executive authority, suspend shares’ (shareholders) voting powers, freeze shares, disallow selling stock and so on. All such court decisions are done with the aim to protect the lawful property rights and claims. Unfortunately, often such decisions are used in illegal “hostile takeovers”.

In any scenario, the “hostile company” has to get the shareholders’ approval regarding the issues of corporate governance. There are many “abuses” or “wrongdoing” related to shareholders’ meetings and company shares’ registries.

In order to obtain the “necessary” decision, the party to a “hostile takeover” may breach the shareholders rights and law by open falsification of the shareholders’ meetings protocols, convening the alternative shareholders meetings that appointment of new executive and oversight Committees, manipulating shareholders’ meeting quorum by denying access of shareholders who may own jointly more than 40% of stock, denying access or registration of shareholders at the general meeting, convening meetings at the poorly accessible or hard to find premises, forging powers of attorney, multiple registrations before the vote on “necessary” issues, incorrect counting of votes by the Mandate commission (controlled by the Executive Committee).

The company stock Registrar plays an important role in “hostile takeovers”. The “hostile company” may attempt to buy the Registrar before the attack, or buy (bribe) the information from the shareholders’ registry. Control and/or access to the shareholders’ registry allows to delay the registration of new shareholders (on official grounds despite 5 days period provided by the law for shares’ property rights registration), use older version of registry at the general meeting (ignore new owners), convene an alternative general meeting, certify the powers of attorney for the proxy vote etc.

In some cases of “hostile takeovers” it is just a criminal offense while in others it is a result of mismanagement and conflicting legislation.

2. Company liability.

The “hostile company” buys company’s debts and file claims on the company’s accounts and assets. The courts start bankruptcy proceedings. The shareholders are no longer in control of the company. The creditors committee takes over company and recommend (elect) a bankruptcy proceeding manager. In bankruptcy proceedings, company’ creditors may take a decision to issue new stock in order to satisfy creditors’ claims and alienate assets of the company, etc. There is a scheme when a tax pledge is used to start bankruptcy after reassignment of claims.

This type of “hostile takeover” poses higher risks and costs. The “hostile company” objective is to gain control over the creditors’ committee which make decisions regarding the company’s assets and operations. In Ukraine, the bankruptcy law allows creditors to sell and/or restructure assets, debts and capital of the bankrupt company. The creditors’ decision is subject to court approval. The secured claims, tax and labor are to be satisfied before the unsecured creditors’ claims. As a result, the “hostile company” is interested in debts with collateral on assets of the company. In this case, it may claim the most lucrative assets of the bankrupt company. Bankruptcy procedure is an extreme scenario since shareholders loose control over their property. The company management with unrestricted powers may put company into debts to a “friendly companies”, pledge, lease or sell the assets of the company and enter into burdensome agreements. On the one hand, such management actions may be used to protect legally the company from the hostile takeover. On the other hand, it may destroy the shareholders value, specifically if it is done without their consent. In most outrageous instances, companies are forced into bankruptcy when the “hostile company” buys outstanding debts, and then change the company accounts and requisites. The “attacked company” can not transfer money to old accounts (pay its debts), and it discovers that a “hostile company” filled a bankruptcy petition. Various scenarios and tactics are applied to defame company reputation and disrupt business operations that affect the solvency of the targeted company.

3. Company management.

The company Chief Executive Officer (CEO) has the extensive powers to support a “hostile” takeover”. The shareholders may significantly reduce the powers of CEO by delegating certain powers to the Oversight Committee (Board of Directors). Since the CEO manages the operations of the company, the unrestricted authority over purchasing and loan decisions and company assets are frequently used to drive the company into bankruptcy (insolvency) and/or strip most valuable assets. In Ukraine, the shareholders’ powers of attorney may be certified in shareholder absentia by the Executive Committee or company Registrar. In proxy fight, the “hostile company” may falsify the powers of attorney for the shareholders meeting taking into account that the company manager or Registrar does not have to verify the shareholders’ documents (identity). As a result the shareholders’ meeting might make an unlawful decision on changing the company’s Board and Executives, which is lengthy to contest. Besides the certification powers, management may manipulate and influence the shareholders in the company labor force, the Mandate and Votes Counting Commission at the shareholders meeting, access shareholders’ registry and exert pressure on the Registrar etc. The poor internal control system gives the company executives additional flexibility in performing or assisting a “hostile takeover” attack.

4. Contending the “privatization deals”.

The “hostile company” buys a minority stock in the company that was privatized by the State Property Fund and brings a lawsuit contending the “results” of privatization. The lawsuit is targeted at majority shareholders claiming breach of shareholders rights in privatization procedures. It is enough to buy one share of company stock to initiate such lawsuit.

For this type of “hostile takeover” to succeed, it is necessary to obtain court decision that freezes the contested shares before the final court verdict. After that, the shareholders’ meeting is convened at the request of minority shareholder. According to the court decision the shareholder with contested stock is not allowed to register and vote at the shareholders’ meeting. This may lead to a shareholders’ meeting decisions that requires simple majority such as appointment of new company executives.

Potentially, Ukrainian stockholders may institute a new scheme when shareholders delegate authority of operational management to the third company. Essentially, as a result of such decision, the third company will gain control over company’s finances and operations. This scheme is used in the Russian Federation and not directly prohibited by the Ukrainian law.

The numerous legal claims, various inspections and commissions also might be initiated. The end purpose of these campaigns, frequently on the verge of breaching the law, is to takeover “control” over a targeted asset at the lowest price possible.

Until recently, change of corporate management/control had a great deal of publicity due to participation of the Ministry of Interior military units. The participation of these units in corporate disputes is effectively terminated, although the forced seizure of premises still takes place with the use of private security units.

In every scheme, the successful hostile takeover depends on a court or/and general shareholders’ meeting decision. While the hostile takeover is not an unlawful action, the tactics and methods used are often performed with a breach of law and shareholders rights.

Risk factors and defense tactics

Certain companies (assets) are easier targets in hostile takeovers. The companies that have

- i) numerous shareholders with relatively small stakes in the company,
- ii) conflicts between the shareholders,
- iii) extended powers of the Executive Committee,
- iv) assets acquired with a breach of law or privatization procedures, and

- v) government and labor shares (ownership) in the company.

Most defense tactics are based on efforts to make lucrative assets unattractive or excessively expensive to the “attacker”, active counter actions (counter purchase of stock or even “attacker” assets). In Ukraine, well-prepared company Statute and internal regulations, adherence to all legal and procedural norms and introduction of internal controls system will reduce the risk of a hostile takeover. Also, joint – stock companies resort to establishment of limited liability companies or private corporations when shareholders put their stock as their contributions to the new companies.

Government efforts

The Ukrainian government voiced its determination to fight the illegal corporate takeovers. Up to date the following steps have been undertaken:

- The President of Ukraine issued the Decree “On measures to improve property rights protection” that tackle the issues of illegal corporate takeovers and corporate conflicts. According to the Decree several particular steps are to be implemented to improve property rights protection in Ukraine, including approval of the Law on Joint Stock companies, improvement in government management of the its corporate rights and development of draft laws on property rights protection of shareholders.
- The Cabinet of Ministers of Ukraine established the Interdepartmental Advisory Commission on Illegal Takeovers chaired by the First Deputy Prime Minister M. Azarov (February 2007). The Commission prepares recommendations as to necessary steps to fight illegal takeovers. Also, the Commission is a “last resort” to companies that try to defend against the illegal takeover efforts. As of June, 2007 the Commission considered dozens of cases and made recommendations to other government structures to prevent unlawful takeover efforts in a number of cases. The regional branches of the Interdepartmental Commission are established in each region of Ukraine. The members of the Commission are scheduled to visit companies that requested review of their cases. Although, the Commission does not have an authority to interfere in a particular case, its presence is every region and recommendations are an effective restraining measures to reduce the scope of unlawful takeovers efforts. Since, it has reviewed a large number of cases, it may focus on elaboration of changes in legal framework and public governance, so its ad hoc interference will not be necessary.
- The Interdepartmental Commission on Illegal Takeovers prepared i) draft Law on changes to “Court of Arbitration Procedural Code”, “Civil Code”, “On renewal of solvency of enterprises or bankruptcy”, “On State Executor Service” and “On State Registration of Legal Entities and Individuals” ii) draft Law on changes to “Criminal Code”, “Criminal Procedural Code” and “Administrative Code” regarding law violations with securities.
- The Supreme Council of Justice submitted a petition to the Verhovna Rada (Parliament) and President of Ukraine with a request to dismiss a number of judges for breaching the oath.

- Ministry of Justice prepared changes to the Law on “Status of Judges”. These changes will allow starting disciplinary liability proceedings against judges if cases under their review are unreasonably delayed. The Cabinet of Ministers researches the issue of simplifying Verhovna Rada procedure to hold a judge criminally liable in case of breaching the law (Criminal Code).
- The Securities Commission regularly monitors operations of dozens of stock registrars that were involved in illegal takeovers. Several licenses were revoked. Unfortunately, in some instances the courts renewed the licenses of registrars that Securities Commission revoked in connection with “raidering”.
- The State Property Fund started registry of the “doubtful” court decisions in corporate and property conflicts as one of the efforts to fight illegal corporate takeovers and unlawful courts’ decisions.
- Verhovna Rada considers amendments to the procedural Codes to allow the corporate disputes to be considered only at the district courts where companies are registered /improve enforcement/.
- Verhovna Rada passed the first reading of the Law on Joint Stock company (Public Corporation). Besides that, Ministry of Justice submitted draft law to Verhovna Rada that covers a number of important issues of corporate governance, including resolution of conflicts between the Law on Legal Entities and Civil and Economic Codes, clarification of provisions regarding procedures on introducing changes to the statutory documents of the legal entity, pledges of shareholders’ shares in the entity, claims on shareholder’s share (corporate rights) in the entity, procedures on transferring corporate right to a third party etc.
- Verhovna Rada registered the draft law “On changes to the legislation in regard to criminal responsibility for illegal takeovers” prepared by Y. Timoshenko and S. Mishenko.
- The State Prosecutor Office established a study team to research the issue. The State Prosecutor Office submitted a petition to the Verhovna Rada with a request to ban the private security firms’ participation in enforcement of the courts’ decisions or protection of the State executors (under threat of revoking the license).
- The Ministry of Interior banned the participation of its units in corporate disputes except under special authorization of Deputy Minister of Interior.
- There are a number of private initiates and advocacy groups, including Ukrainian Union of Industrialists and Entrepreneurs, American Chamber of Commerce, Corporate Conflicts Research Center, and others.

Recommendations

Improvement of the corporate law, strengthening of the judicial system and fighting corruption should be the long – term government objectives in development of the effective mechanism for the property rights protection. In the short run, the government should undertake several further

steps that might help in curbing the unlawful hostile takeovers. The most important of all is to set the tone and create an atmosphere of intolerance to any breaches of law, in regard to corporate property rights, in particular. Deputy Prime Minister N. Azarov voiced the government determination to fight “raidering”; interdepartmental advisory commission was established and several particular steps (decisions) approved. These efforts should be sustained and accompanied by nation - wide publicity. Since the term “raidering” is not adequate, the issue should be rather addressed in terms of law violations in the field of property rights. In particular, the following measures might improve the situation with “unlawful hostile takeovers”:

- National Registry of claims in courts of arbitration and general jurisdiction should be created. It might be similar to the unified Registry of court decisions maintained by the State Judicial Administration of Ukraine. Although, it could be maintained on a fee basis. Courts’ decisions and resolutions are submitted to the registry within 15 days after their approval; therefore this information can not be used for timely appeal purposes (in case of late court notifications). Information from the registry of claims will allow companies to access information in time and become better prepared for the “defense”.
- As soon as possible, the amendments to the procedural Codes should be approved, so the corporate disputes will be considered only at the district courts of business entities’ or entrepreneurs’ registration. While the law explicitly states that claims to legal entities should be review at the district courts of their registration, several exceptions in the law seems to allow courts to accept claims all over the country. Although, it appears that this is the problem of enforcement of the legal norms.
- The mechanism of judges’ liability for the breach of oath (substantial breach of material and procedural legislation) should be strengthened and persistently applied. The current procedure of holding the judge criminally liable for substantial breach of law is almost impossible to complete (bring to justice). The disciplinary liability proceedings rarely result in dismissal of judges from their duties.
- The reform of the national depository system should be accomplished. The manipulation with company’s registry including duplicate registries are used in illegal takeovers. In case of reform, the registrars will only be able to retrieve and submit information on shareholders from a central depository database that makes impossible to falsify the shareholders information. In Ukraine, there are about 400 licensed registrars. The Securities Commission published draft decision to collect electronic copies of registries each month as an initial step in this reform.
- The Securities Commission should take a pro-active role in improving the corporate governance and internal “company defenses” against a “hostile takeover”. The Commission may review its recommendations on the Statute and internal documents for the joint-stock companies and establish a set of shareholders meetings’ procedures and internal controls that will be mandatory for the joint – stock companies (subject to official registration). Also, the Commission might consider development of the Code of Ethics in corporate mergers and acquisitions similar to one in EU.

- The draft law on “Joint Stock Company” (approved in the first reading) is a step forward in enhancing the corporate legislation, including prevention of the unlawful “hostile takeover” attacks. According to the draft law, the powers of the Supervisory Boards will be substantially extended. The procedures of the Shareholders’ and Supervisory Board meetings are proscribed in greater detail. There are provisions to prevent transactions with assets of the company without shareholders’ consent and restrict the shareholders’ property rights. The notion of the stock market value and provisions on protection of minority shareholders rights are introduced.
- Strengthen the criminal and administrative systems’ responsibilities (crimes with aggravating circumstances) in regards to breach of the property right, such as forgery of documents, misleading of the court, shareholders’ rights violations by the corporate executives etc.
- While the Constitutional right for protection of the civil rights shall be upheld, the courts should attempt to minimize their interference in the decisions that fall within the authority of the shareholders’ meetings. When court considers an arrest of movable and/or immovable property in corporate disputes, the plaintiff demands should be satisfied within the plaintiff (stockholder) share (ownership) in the company. The recent proposals of the Ministry of Justice (draft law submitted to Verhovna Rada) appear to attempt to introduce this change.
- The courts may be required to verify submitted plaintiff information within their current capabilities.
- The State Executors Service should be required to verify the authenticity of court decisions submitted for execution.